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Special bulletin no. 17 (1923, February); Capital stock; Newsprint paper mill; Stock dividends; Commissions; Dividends; Ice cream costs; Mortgage investment company

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FEBRUARY, 1923 SPECIAL BULLETIN No. 17

[The Committee on Administration of Endowment authorizes the publication of special Bulletins, of which this is one, on the distinct understanding that members are not to consider answers given to questions as being official pronouncements of the Institute, but merely the individual opinion of accountants to whom the questions were referred. It is earnestly requested that members criticise freely and constructively the answers given in this or any other Bulletin of this series.]

CAPITAL STOCK

The special bulletins issued by the Institute invite criticism with regard to answers given to questions in the bulletin. I need not, therefore, apologize for taking exception to one of the answers in Special Bulletin, No. 15. I refer to the first question in that bulletin which relates to the statement of capital stock in circumstances which are rather extraordinary.

May I be permitted to say, however, that however repugnant the transaction referred to in the question may be to accountants, the answer is not responsive. The question itself, in my opinion, is incomplete in the sense that it does not give the state under the laws of which the transaction was put through. I am inclined to think, however, that the transaction, as stated in the question, is one which would be legal in certain states, but I do not think it can be answered intelligently without knowing under what guise of legal authority it had been done.

Assuming, however, that I am right in my belief that the transaction was legal, it seems to me that your correspondent, and every other accountant confronted with situations perfectly legal, but somewhat unsound, needs to be informed as to the way in which the transaction should be reflected in a balance-sheet. I have been accused myself of being a heretic, because I insisted it was the duty of an accountant to recognize a legal fact and to reflect it literally in a balance-sheet, but in such a way as not to mislead. If there is a legal method of doing a thing there must be an accounting method of recording the fact and the accountant should adopt that method whether or not in his opinion the law is a sound one.

In the case under discussion my suggestion is that the proper method of stating the capital of the company is as follows:

Capital, $16,000.00.

> represented by capital stock of the par value of $2,100,000.00, consisting of 2,100,000 shares of a par value of $1.00 per share issued in exchange for 105,000 shares of no-par value of a stated or paid-in value according to the financial plans filed under the laws of the State of ———— of $16,000.00.

Your correspondent in answering the question suggests that the company should come down to earth. The promoters will be lucky if it stops there.

NEWSPRINT PAPER MILL

In accordance with the invitation at the head of Special Bulletin No. 15, I beg to offer the following criticism of the answer to the "Newsprint Paper Mill" question:

As I read the question, it is to be definitely assumed that the quantity of newsprint manufactured during the period was 10,000,000 pounds, which would not be affected in any way by the spoiling of wood pulp.

The item that would be affected is the cost of $800,000.00, which would be increased to $835,000.00, due to the closing inventory of materials being that much less in value than was at first reckoned. In other words, the "total cost" of $800,000.00 would not actually be the total cost, by reason of the fact that the spoiled wood pulp had been erroneously included in the closing inventory.

STOCK DIVIDENDS

Q. When a stock dividend is declared in the case of a stock having par value, it is clear that the surplus account will be reduced and the capital stock account increased by an amount equal to the number of shares issued as a stock dividend multiplied by the par value thereof.

In the case of a stock dividend declared in no-par capital stock, what amount, if any, should be transferred from the earned surplus account to the stated value of the no-par capital stock?

A. The following opinions have been received:

A stock dividend declared in no-par capital stock should read to the effect that a dividend of blank dollars per share is payable in stock. At the date of payment a corresponding amount will be transferred from earned surplus to capital, thereby reducing the available earned surplus for cash dividends and accomplishing one of the main objects of a stock dividend. The amount of surplus so transferred would, of course, be optional with the board.

Our opinion must be given with certain reservations, because the state in which the corporation operates is not supplied, but generally speaking, in absence of action by the directors fixing the dollars per share or amount to be transferred, there would be a choice of two ways: one, the number of shares included in the dividend times the stated value per share, or that percentage of the stated or of the actual capital, which the number of shares of the dividend bears to the number of shares previously outstanding.

Where a company is incorporated in a state requiring no stated value to be carried of no-par-value stock, surplus account might be taken as representing the value or equity of such stock and only a memorandum capital stock account, without values, need be carried. In this case, no transfer would be made and notation only of the dividend and the corrected number of shares outstanding would be necessary.

As a general rule, however, companies incorporated with no-par-value stock have on their books a capital stock account for such stock in the amount that the assets acquired were in excess of the total of liabilities and the par value of preferred stock issued or at least a proportion of such excess. In such instances where no stated value is required, no transfer from surplus would be necessary.

Where, however, the certificate of incorporation calls for a stated capital of so much per share outstanding, a transfer of that amount times the number of shares distributed as a dividend should be transferred to the already opened capital stock account. This account would then show the total shares outstanding at the stated value per share.

Again, if the certificate of incorporation calls for a round amount of stated capital and not a per share value of stock outstanding, this round amount would appear on the books as the capital, and would not be altered by a transfer upon the payment of a stock dividend of no-par-value shares, unless with that end in view the charter was altered, in which case a corresponding figure would be transferred from earned surplus.

A stock dividend on no-par-value stock is in itself merely a means of increasing the number of outstanding shares. Such a dividend, if coupled with the capitalization of a part of the earned surplus, appears as reasonable a proceeding as the declaration of a stock dividend on a par-value stock. The transfer to capital account of a portion of the surplus could probably be accomplished by a resolution of the directors, but this is a legal question concerning which state laws may vary, and upon which one should obtain competent legal advice.

The usual method followed in declaration of stock dividends is for the board of directors to pass a resolution containing about the following:

"———— to stockholders of record of ———— date a dividend of —— per cent. payable in the common capital stock of this company to be issued at par." Quite frequently the total amount to be distributed is named in place of or in addition to the per cent.

It would seem that if there were a stated value per share of the no-par capital stock, that if a stock dividend were then declared and that if the resolution provided for distribution of a given number of shares of stock without mention of the amount of money, which those shares represented, then the transfer from surplus to the stated value of the no-par common stock would be the stated value per share multiplied by the number of shares distributed. However, the query arises why a corporation should desire to distribute a stock dividend declared in no-par stock unless it also desired to sell additional shares to obtain new capital and the stock dividend is resorted to in an attempt to equalize equities as between the old shareholders and the new shareholders in the event the latter should buy shares at a lower price than the known or assumed true value of the stock.

The differences in no-par stock laws of different states and the doubtful points involved in their interpretation are so great and the entire subject of no-par stock is so beset with uncertainty and opportunities for transgressing both moral and economic laws, that we are loath to answer this abstract question by any statement of general application. All of the facts involved in and surrounding the proposed action should be known before deciding upon either the propriety of the stock dividend itself or the bookkeeping entries involved thereby.

The question of the values to be set up for no-par capital stock is one that is subject to a great many interpretations. In the first place, no-par capital stock is quite frequently issued without any amount being paid in therefor, either in cash or in other property. The real value behind each share of no-par stock is the total of the capital stock account (if any is set up), plus the total surplus account divided by the number of shares of no-par stock issued. If a stock dividend is issued in no-par stock, the total of these two accounts remains unchanged and the value of each share of no-par stock is reduced corresponding to the increase in the number of shares brought about by such stock dividend declaration.

It would, therefore, appear to be necessary that the directors in declaring a stock dividend on no-par stock should state in their resolution that so much value should be taken from the surplus account, transferred to the stated capital stock account, to be divided in the issuance of no-par stock of a certain number of shares at a fixed amount, thus making capital out of what was formerly surplus.

This would have the effect of taking out of this surplus account an amount that would otherwise be subject in the discretion of the directors for distribution as cash dividend.

In declaring a stock dividend on no-par capital stock, no distribution in money value could certainly be considered unless that amount was stated, and under the new revenue law a serious question might arise as what portion of earned surplus would be accumulated, which might be subject to a 25 per cent. additional tax.

I find on looking through my library that my copy of "Corporation Procedure," by Conyngton, Bennett and Pinkerton, states on pages 1152 and 1153 that "when a stock dividend is payable in stock without par value, the only entry required on the general books is one indicating the number of shares thus disposed of," and that no change is made in the amount of the surplus account or of the capital stock account.

I find, however, on looking at the Journal of Accountancy for December, 1920, on page 459, that Mr. Finney, editor of the Students' Department, furnished as a part of the answer to the question therein contained the following statement:

"The account with stock without par value should be credited with only those amounts actually paid in on the stock, and with any surplus transformed into fixed capital by action of the directors, such action being analogous to the declaration of a stock dividend."

Since receiving your inquiry, we have had quite a discussion in the office on your question, and we have come to the conclusion that we agree with Mr. Finney rather than with Mr. Conyngton, et al.

My reasoning is in this manner:

I have always assumed that the real purpose of a stock dividend was to transfer from the surplus account to the capital account an amount which, so far as possible, would increase the capital account to a sufficient amount to represent approximately the actual capitalization, or an amount which fairly represented the capital which the corporation needed to carry on its business.

If, in the case of declaring a stock dividend of no-par-value stock, it is contended that no change is made in the surplus account, it leaves the corporation where it cannot take out of the surplus account, which is available for dividends, an amount to be added to permanent capital, and this disability prevents withdrawing the amount to a position where it will not be subject to the payment of dividends.

If, however, a cash dividend is declared and the amount of this cash dividend is paid in for new stock, there is no argument against adding the price that the company receives for the new stock to the capital account. This procedure would have exactly the same effect as transferring a similar amount from the surplus account to the capital account and issuing the same number of shares as a stock dividend except that, in the latter case, the stockholders would not be subject to a surtax on the dividend at the time the dividend was declared, but would defer the payment of the tax until the stock received as a dividend was realized upon in cash by them.

Under these circumstances, it would seem entirely obvious that a corporation having no-par-value common stock should not be deprived of its privilege of investing permanently in the capital of the company's accumulated earnings which were actually needed in the conduct of the business and which the directors felt it would be for the interest and safety of the business to have designated as capital instead of as surplus. As I see it, there is no other means of accomplishing this except by declaring a stock dividend, unless a cash dividend is paid to the stockholders and then paid back to the company for new stock.

We have also studied the New York state law regarding no-par-value stock and thus far have been unable to find any requirement of the law which prohibits the payment of a stock dividend.

It is, therefore, our conclusion and opinion that in a case of this kind we should recommend to our client that a stock dividend be declared, that the amount of dividend decided upon be transferred from the surplus account to the capital account, and that the requisite number of shares be added to the outstanding stock. We should expect, of course, to call in the old stock certificates and exchange them for new certificates, which would show the total shares of stock outstanding after the stock dividend.

I presume the question arises, if this is done, as to how many shares should be issued to cover the amount which it was decided to transfer to capital. As you have not asked this question, I will not attempt to answer it except to say that I should judge this might depend very largely upon the circumstances in the case of each corporation and what the directors considered to be the wisest course under those circumstances which might exist.

Any dividend declared, whether in cash or stock, must be capable of translation into dollars and cents. Dividends may be declared as a lump sum; an amount per share; a per cent of the par value of the outstanding capital stock, or a per cent of the credit to the capital stock, no-par-value.

The credit to capital stock account, by a charge to surplus, would be the amount of the dividend declared.

Assume that 10,000 shares have been issued and that a dividend of $10.00 per share payable in stock has been declared, the amount to be transferred from earned surplus to capital stock, no-par-value, would be $100,000.00. The dividend being payable in stock raises a number of points. If the stock has been authorized to sell at $10.00 per share, it would simply be a matter of the issuance of 10,000 shares of stock. Theoretically, there would be no advantage in issuing the additional 10,000 shares, as the original 10,000 shares would have the same book value as 20,000 shares. Practically, there may be quite a decided advantage from the standpoint of selling the shares. It is a well established fact that it is easier to sell 20,000 shares at $10.00 each than to sell 10,000 shares at $20.00 each. This law of psychology is often the reason why stock dividends are declared.

When the stock dividend declared per share is less than, or greater than a multiple of the amount at which additional shares of no-par-value share have been authorized to sell, then it becomes necessary to issue fractional stock certificates to such stockholders whose dividends are less than the authorized selling price of a share or in excess of any multiple thereon.

Naturally, any surplus remaining after all charges and dividends of preference have been taken care of, belongs to the no-par stockholders. Furthermore, the very nature of no-par stock requires that any dividends to its stockholders have to be paid at a given amount per share rather than a percentage per share which obtains in the cases of capital stock having par value.

This being true, it will be necessary that any stock dividend would have to be declared in a definite amount of dollars and in order to cover the outstanding stock in even shares, would have to be in such an amount as represents the per share value then covered on the books or else such value as would represent a fractional value based on the outstanding book value as a capital stock liability.

In this connection I bring to your attention the point made by an extremely able attorney on the question of taxing surplus, that the surplus remaining after all other charges had been covered belong to the no-par stockholders and simply increases the intrinsic value of their holdings. Therefore such surplus would not be taxable by the federal government provided such a tax is eventually instituted.

COMMISSIONS

Q. A manager is to receive 10 per cent. commission after deducting income taxes and $50,000 from $190,000 income. The fiscal year ended August 31, 1922. The invested capital is $500,000.

A. The solution to the problem is as follows:

Commission	$10,612.50
Tax	33,375.04

Attached is a copy of a computation in support of these figures.

Fiscal Year Ended Aug. 31, 1922

A	Invested capital		$500,000.00
	Excess profits credit 8 per cent. of invested capital		40,000.00
	Specific exemption		3,000.00
B	Total excess profits credit		$ 43,000.00
C	Gross income before commission	$190,000.00	
D	Less commission (see K below)	10,612.50	
E	Net income		$179,387.50
	Computation of taxes, 1921 *basis*:		
	Income not over 20% of invested capital (A)	$100,000.00	
	Less excess profits credit (B)	43,000.00	

	Remainder taxable at 20%		$ 57,000.00	$11,400.00
	Income over 20% of invested capital at 40%		79,387.50	31,755.00
F	Total excess profits tax			$ 43,155.00
	Income tax:			
	Net income (E)		$179,387.50	
	Less excess profits tax (F)	$43,115.00		
	Specific exemption		43,155.00	
	Balance taxable at 10%		$136,232.50	13,623.25
G	Total taxes (1921 basis)			$ 56,778.25
	1922 *basis*:			
H	Income tax, 12½% of (E)		179,387.50	22,423.44
	4/12 of G			$ 18,926.08
	8/12 of H			14,948.96
I	Total taxes			$ 33,875.04

Proof

	Income before deducting taxes or commission (C)		$190,000.00
	Less taxes as above (I)	$33,875.04	
	Plus (arbitrary)	50,000.00	83,875.04
J	Net income subject to 10% commission		$106,124.96
K	Commission at 10% of (J)		$ 10,612.50
	Commission as above (D)		10,612.50

You may inform your inquirer that we do not use an arithmetical or algebraical formula for working out problems of the kind submitted by him where there are a tax and commission dependent upon each other.

Formulas could, of course, be prepared, and in the early days of the income tax when these problems arose, we used to devise such formulas, but found in practice that we could arrive at the solution more quickly by what we call a trial-and-error method, that is, by assuming a certain commission and working out the resulting tax on that basis, then adjusting the commission on account of any error disclosed in the proof until we arrived at a figure of commission that would exactly balance with the amount to be arrived at after deducting the final and correct amount of tax.

The arbitrary deduction of $50,000 in the proof is the $50,000 referred to in the first telegram submitted by you. In this telegram it states that the manager is to get 10 per cent. commission after deducting income taxes and $50,000.

DIVIDENDS

Q. I should like to obtain information with reference to handling dividends paid by an oil producing corporation from a reserve for depletion account.

In this instance the reserve for depletion is the result of several years' accruals and at the time the dividends were paid from this depletion reserve, there was no surplus.

What accounts are used on the general books to record the handling of the dividends?

In preparing a balance-sheet at the close of a fiscal year, how are the accounts effected by the reserve for depletion and the dividends reflected on this statement?

A. We know of no accounting theory which countenances the declaration of dividends out of a reserve for depletion. This reserve, if it represents what the title of the account indicates, is merely an offset to the value of the property, and is built up through a charge to cost and credit to the reserve, based on the estimated production.

The usual entry for dividends is to charge dividends declared and credit dividends payable. In the closing accounts the charge for dividends payable goes against the surplus, while the liability for the payment of the dividends appears on the balance-sheet. This, of course, is all predicated on the assumption that the dividend is not to be paid until after the date of the balance-sheet.

On the balance-sheet the reserve for depletion appears either as a deduction on the asset side from the property account, or on the liability side, depending on the procedure with regard to the preparation of the balance-sheet. The liability for dividends payable appears on the right-hand side, under the head of current liabilities.

ICE CREAM COSTS

Q. Please advise if you have anything relating to costs in connection with the manufacture of ice cream.

A. The Bureau of Information has received the following statistics:

COST ON GALLON BASIS FOR THE YEAR 1921

On hand Dec. 31, 1920	3,355	gals.
Made year 1921	397,074	"
	400,429	"
Less on hand Dec 31, 1921	3,768	"
Made to sell	396,661	"
Actual sales	395,711	"
Short	950	"

Gallons made, 397,074:	Cost	Per gal.
Ingredients	$175,275.43	44.1c
Mfg. wages	$ 10,238.11	2.6
Power house expense	10,938.56	2.7
Packers and papers	6,251.09	1.6
Coal, light and power	11,570.84	2.9
Repairs	9,567.83	2.4
Ice	10,734.29	2.7
Salt	11,299.77	2.9
Repairs, tubs, cans and cabinets	6,246.69	1.6
Porters, oils and general expenses	17,806.32	4.5
	$ 94,653.50	23.9
Drivers' and salesmen's wages	$ 20,058.00	5.0
Auto expense and gas	25,343.08	6.4
Advertising	28,229.42	7.1
Express and sundry delivery	46,098.37	11.7
	$119,728.87	30.2
Office expense	$ 13,527.82	3.4
Superintendents and officers	21,325.00	5.4
Interest, taxes and insurance	8,097.67	2.0
Bad debts	1,881.04	.5
Depreciation	31,981.64	8.0
	$ 76,813.17	19.3
Total expenses	**$466,470.97**	**117.5**
Profit	**36,934.22**	**9.3**
Selling price	**$503,405.19**	**126.8c**

MORTGAGE INVESTMENT COMPANY

Q. 1. A mortgage investment company loans money on a mortgage amounting to $10,000.00, maturing in five years, interest at 7 per cent, payable semi-annually. On this the mortgagor receives only $9,000.00. Thus the mortgage company has an earning in excess of the stated interest of $1,000.00. The security for this mortgage would be real estate of an appraised value in excess of $20,000.00. The mortgage company has been accustomed to taking the discount into their earnings in the month when the mortgage was entered into. Contemplating an audit they wish to have their accounts set up in such a manner that the auditor will be justified in giving them an unqualified certificate as to both balance-sheet and income statement.

(a) Should such discount be amortized over the life of the mortgage or should it be reserved as an earning at time of maturity?

(b) Should this mortgage be set up as an asset at $10,000.00 with an opposing account representing unamortized discount or should it be carried at its cost, $9,000.00, with no offsetting account?

2. A mortgage company deposits its mortgage securities with a bank under a trustee agreement and the trustee certifies the mortgage company's collateral trust bonds, 20-year maturities bearing interest at 6 per cent. against the securities. The mortgage company then through its own sales organization places these collateral trust bonds on the market, paying the salesmen a commission of 10 per cent.

(a) Should the commission paid the salesmen be absorbed as a business expense in the month when the bond is sold, along with the expenses of the sales department, or, (b) should this commission be amortized over the life of the bond in the same manner as would be done if they had sold these bonds to an investment banking house at a discount?

The first question is very similar to the one appearing in Special Bulletin No. 9, page 7, but I believe taken in conjunction with the second question that it might call for different treatment than if it stood entirely alone.

A. 1. (a) The ordinary procedure in the case of discount on bonds or mortgages is to amortize the discount over the life of the investment, and in the case of the $1,000.00 discount referred to in this question it would be proper to apportion the discount, at least with approximate accuracy, over the life of the mortgage.

(b) The mortgage may be set up in the books at $10,000.00, and an unamortized discount account carried as a deferred credit for $1,000.00. Periodically at the time of interest payments the portion of the discount earned should be transferred to interest income. In the balance-sheet the unamortized discount may be deducted from the face value of the mortgage, or may be shown as a deferred credit on the liability side of the statement.

2. The expense of marketing the bonds referred to should not be confused with ordinary selling expense and may be set up as a deferred charge to be apportioned over the life of the bonds, just as if the bonds had been sold at par, less 10 per cent., through an investment house. It would be conservative, however, to write off the expense in the period in which it was incurred.

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1. (a) If each year is to receive its proportionate share of income, the discount should be apportioned over the life of the mortgage. If the discount is reserved until maturity of the mortgage, the amount thereof will appear in earnings in the last year only, unless, of course, the last year is credited only with its proportion of discount and the remainder credited to surplus. The first-named method appears to us to be preferable.

(b) Either method is correct. It is a more or less uniform practice for mortgage companies to set up their loans at par with an opposing account representing unamortized discount.

2. Commissions to salesmen should be treated as a selling expense in the month in which the sale is made.